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Do Tough Economic Times Put Pressure on Procurement Managers to Favor "Unit Price" over Total Cost?

Beware the Low Price that Brings Significant Risk along with It

SCDigest Editorial Staff

Most supply chain managers understand in theory the concept of "Best Total Value" or "Total Supply Chain Costs," but sometimes putting it into practice may be difficult. That may be especially so in the current economic climate.

Those two terms and others are used to describe the basic and fundamental concept that procurement organizations should focus on the lowest cost to the organization from a product they purchase, rather than simply the lowest "unit price" for that part or commodity.

As **Dr. Ed Marien** of the University of Wisconsin and his own consulting practice explained last year to SCDigest, "There are several aspects of price, of course, but the key concept has to do with looking holistically at the buyer's side of costs, not just the supplier's price. It's obviously not only purchase and delivery price that matters, but your internal costs for acquiring, managing and using that product or service."

But most procurement experts believe that while the concept of selecting a vendor that offers truly the "best value" or "lowest total supply chain cost," rather than just the lowest "price," is generally accepted as a best practice, that mindset is in fact very difficult to put into practice in many organizations.

Why? There are several reasons. First, it may be difficult or even impossible to really ascertain what the other operational costs are associated with using a given vendor's products. For example, what really is the value of an effective Vendor Managed Inventory program offered by one vendor?

To do that, will those suppliers be cutting corners – and in reality add to what looks like a sweet deal a large amount of hidden risk?

Second, those additional costs are less visible than purchase price, and often open to more subjective assessments than the black and white unit price.

Third, procurement managers are often incented/evaluated on their ability to manage costs at the unit price level, versus previous years and/or some commodity index, not total cost or best value.

Challenges Exacerbated in Recession?

Those pressures to focus on purchase price are most likely exacerbated during tough economic times. Reducing the purchase price may seem like a quick win to help the bottom line as the top line sags, and on an apples-to-apples comparison it certainly is.

Nevertheless, companies are best served by maintaining the focus on lowest total cost, says **Herb Shields** of HCS Consulting.

"A professional buyer would have to ignore recent history to adopt the approach of buying based on lowest unit price," Shields told SCDigest.

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Logistics cost and quality issues are just two examples of factors that need to be well analyzed, Shields notes.

"Recent examples of purchases that were impacted by high quality costs include the toy product and milk product recalls that occurred on products produced in China," Shields adds. "This year we have also seen peanut product recalls here in the USA. Some of these purchases were probably made based on lowest unit cost thinking without recognizing the potential impact of poor quality."

Shields says the current environment is one fraught with risks for procurement organizations.

For instance, the current recession will lead to some suppliers to offer products at a very low or "distressed" price levels in an attempt to keep plants running or other considerations. But to do that, will those suppliers be cutting corners – and in reality add to what looks like a sweet deal a large amount of risk?

"Purchasers have to remain more strategic in their thinking," Shields adds. "From a risk management perspective, I am advising companies to ask this question: How do I evaluate the risk that my current and potential suppliers will not survive 2009? Choosing suppliers based on lowest unit price likely increases this very real risk."